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IN THE  
Supreme Court of the United States

OCTOBER TERM, 1962

No. 476

BENJAMIN BRAUNSTEIN and DIANA BRAUNSTEIN; Estate of Benjamin Neisloss, Deceased, JULIA NEISLOSS and RUSSELL NEISLOSS, Executors, and JULIA NEISLOSS; HARRY NEISLOSS and LILLIAN NEISLOSS, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

On Writ of Certiorari to the United States Court of Appeals  
for the Second Circuit

REPLY BRIEF FOR PETITIONERS

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**COMMISSIONER OF INTERNAL REVENUE, Respondent.**

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**On Writ of Certiorari to the United States Court of Appeals,  
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**REPLY BRIEF FOR PETITIONERS**

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Apparently the Commissioner is not too pleased with the opinion of the Court of Appeals. The court agreed that the corporations were not used as a means of converting ordinary income from the development into capital gain. Moreover, the court unkindly indicated that to apply the statute in such circumstances

"produces unwarranted taxation of capital gains as ordinary income." (R. 36.) In an effort to compensate for these difficulties the Commissioner's brief consists largely of arguments that have not been made before. These arguments are designed to re-rationalize the decision below on something more than a so-called "literal" reading of the statute. Since the Commissioner has felt obliged to go off in new directions, this brief is necessarily much more extensive than it would otherwise have been. However, the Commissioner has left us little choice in the matter.

The resolution of this case turns on the meaning of the words "gain attributable to such property" in section 117(m). The Commissioner, it seems, does not entirely understand our position—indeed, he apparently regards it as mere pretense. (Resp. 16.) Hence we deem it appropriate to restate our views before examining his various arguments and assertions.

Section 117(m) is a special statute designed to cope with a particular problem. This problem is the use of certain corporations as a means of executing a certain scheme of tax avoidance. The corporations involved are entities "formed or availed of for the manufacture, construction, or production of property." The planned avoidance consists of realizing as a capital gain the regular business profit from the property—profit normally taxable as ordinary income to the corporation, or to the stockholders if they individually produced, owned, and operated the property. This conversion of ordinary income into capital gain is effected through a sale or exchange of stock in the corporation. Therefore, section 117(m) provides that the profit realized on the sale of the stock is taxable

as ordinary income only if the property was produced with a view to (1) the shareholders' sale or exchange of the stock before the corporation itself realized a substantial part of the net income to be derived from the property; and (2) the shareholders' realization of "gain attributable to such property." The "gain attributable to such property" is the profit which would be regularly realized as ordinary income from the property in the absence of the scheme to avoid. As the Court recently stated in analogous circumstances, it is "a substitute for what would otherwise be received at a future time as ordinary income" from the property. *Commissioner v. Lake*, 356 U.S. 260, 265 (1958). See Pet. 25. The purpose of section 117(m), then, is to reach a disposition of stock which attempts to "make a transaction something else than it truly is." Cf. *Commissioner v. Wodehouse*, 337 U.S. 369, 410 (1949).

Here we do not have any such situation. The sale of the stock did not enable the petitioners to transform ordinary income from the property—the profits "arising from the everyday operation of a business"—into capital gain. Cf. *Corn Products Co. v. Commissioner*, 350 U.S. 46, 52 (1956). See Pet. 51, 79. If the corporations had sold the development, the resulting profit would have been a capital gain. And if the petitioners had individually built and owned the development, the profit would have also been a capital gain. (Pet. 38-39.) The problem with which the Treasury and Congress were so rightfully concerned is nowhere in sight. The Treasury has not been deprived of any tax to which it is otherwise entitled. In fact, the Treasury is better off than it would have been if the petitioners had built and owned the development as individuals. See pp. 51-

52, *supra*. Finally, the Treasury's interpretation perverts the statute. It converts capital gain into ordinary income merely because taxpayers conduct their business through a corporation, and realize a profit through a sale of stock rather than the underlying property. The Court of Appeals itself conceded that its decision was not in accord with the stated policy and design of the statute. (Pet. 78-79.)

We now turn to the contents of the Commissioner's brief. In our view his arguments rest on a number of misconceptions both of law and of fact. Moreover, much of his discussion proceeds on the pleasant premise that taxation is a matter of pure reason, in which he may freely speculate to suit himself.

#### THE COMMISSIONER'S STATEMENT OF THE QUESTION PRESENTED

The Court has granted certiorari limited to the following question: "Whether Section 117(m) of the Internal Revenue Code of 1939, which provides that gain 'from the sale or exchange . . . of stock of a collapsible corporation' is taxable as ordinary income rather than capital gain, is inapplicable in circumstances where the stockholders would have been entitled to capital-gains treatment had they conducted the enterprise in their individual capacities without utilizing a corporation." (R. 42.) The writ was confined to this question in response to the Commissioner's request. Indeed, the question is in precisely the language as he proposed it. Brief for Resp. on Pet. for Cert. 1-2.

Evidently the Commissioner has become unhappy with the result of his prior efforts. Instead of abiding by the question expressed in the Court's order, he would now improve upon it. The question, as re-

vised by him on his own, is "whether the application of" section 117(m) "is dependent upon a finding in each case that there was no other way for the stockholders to convert the values created by the construction into capital gain." (Resp. 2.)

It is quite obvious why the Commissioner is anxious to rewrite the question. If taxpayers individually construct and operate a development as rental property, the profit realized on a later sale is a capital gain. Int. Rev. Code of 1939, § 117(j). The fact that they contributed their services to the construction is immaterial. Congress regards the difference between the cost and the proceeds as a true capital gain. See further pp. 26-27, *infra*. The purpose of the altered question is to insinuate that the treatment prescribed by Congress is a loophole, and that builders are inherently tax avoiders—converting ordinary income into capital gain—whether they construct and operate their rental properties as individuals or through corporations. In this way the Commissioner hopes to envelop the case in what he considers an appropriate atmosphere. See further pp. 37-38, *infra*.

#### THE COMMISSIONER'S SUMMARY OF THE FACTS

The Commissioner's statement includes many items which the Court of Appeals considered wholly irrelevant to the question presented here. Compare Resp. 2-8 with R. 35-39. These items are largely concerned with the cost of constructing the development. As we later indicate, they are now imported into the case in a belated effort to find some new ground for sustaining the decision below. See p. 32, *infra*. As we further show, the Commissioner has thoroughly misunder-

stood, the figures as they relate to the builder's and architect's fees. See pp. 40-43, *infra*.<sup>1</sup> At this point we merely note that he has been less than fully accurate in regard to other items—aside from their irrelevance to the question before the Court.<sup>2</sup>

#### THE COMMISSIONER'S ARGUMENTS ON THE LAW

On analysis, the Commissioner's contentions boil down to three arguments. The first is that the profit realized on the sale constituted the required "gain," regardless of whether any ordinary income from the property was converted into capital gain. The second is that the profit was necessarily a conversion of ordi-

<sup>1</sup> The Commissioner implies that the F.H.A. expected the eventual cost of construction to include the payment of builder's and architect's fees. (Resp. 5.) However, the F.H.A. knew well in advance that, in accordance with its established procedures, no such fees were to be paid. The amounts attributed by the F.H.A. to such fees were a means of computing the amount of the mortgage loan. See p. 40, *infra*.

<sup>2</sup> For example, the Commissioner states that there were substantial savings in construction "attributable largely to the fact" that the building partnership "did not (as the estimates had assumed the builder would) contract out the carpentry, plumbing, and heating work but performed the work itself, thereby effectively eliminating from the costs the subcontractors', as well as the builder's and architect's, normal mark-up." (Resp. 5.) The Commissioner fails to add, as the Tax Court found, that the savings were unexpected, not planned. (A. 227-228.) See further p. 46, *infra*. Or, to cite another example, the Commissioner states that "by September 1, 1949, all units were occupied." (Resp. 6.) The evidence is precisely to the contrary. The units were never fully occupied while the petitioners owned the stock in Springfield and Hill. In the first five months of 1950 the vacancies for apartments and garages averaged about 9 percent per month. By September, 1950—the time originally fixed for the closing—the vacancies stood at 13 percent. These percentages reflect the ratio of total vacancies to total gross potential rents as stipulated by the parties. (A. 237.) See also Pet. 5, 7.

nary income into capital gain because the corporations engaged in the construction of property. The third is that in any event the proceeds represented a conversion of compensation for services. The second and third arguments are advanced here for the first time. Until now the Commissioner has been unaware of those contentions, and has relied on the first argument alone. We will now consider the three arguments in the same order.

### I. THE FIRST ARGUMENT

The animating legislative policy enclosed within section 117(m) is to prevent normal business profits on constructed property from being realized as capital gain. We are happy to say that the Commissioner "fully" agrees. The "admitted" and "basic purpose of the statute," he states, "is to prevent the conversion of ordinary income into capital gain." (Resp. 9, 17, 22.) He also goes a significant step further. He commendably emphasizes that "statutory language should be read—indeed, even strained to some degree—to avoid absurd results, to carry out the discovered purposes of Congress, and in general, in an effort to produce a rational, sensible structure." (Resp. 18.) Nevertheless, the Commissioner incongruously argues that section 117(m) applies here, regardless of whether the sale of stock effected the required conversion. (Resp. 8, 14.) Despite the conceded fact that the Treasury and Congress were solely concerned with ordinary income masquerading as capital gain, the Commissioner contends that "the underlying nature of the gain" is entirely immaterial. (Resp. 14.) In short, as we understand his position, in this case, unlike other cases, the Court need not be concerned about

"absurd results," "the discovered purposes of Congress," and "a rational, sensible tax structure." The asserted deficiencies must be sustained, no matter how absurd and irrational the result may be. Or, to put it a little differently, the Commissioner is prepared to justify Mr. Bumble's celebrated observation that "If the law supposes that," then "the law is a ass."

The Commissioner offers several reasons in behalf of this peculiar conclusion. Apparently his basic reason is that "the words of the statute are quite incapable of carrying the meaning that petitioners would give them." Then he adds these other reasons: Our construction "conflicts with the regulations; is contrary to the settled assumptions of commentators, litigants, and the courts for many years; and would make a nullity of an express, and much narrower, limitation later added by Congress." (Resp. 9.) Each of these explanations leaves a good deal to be desired.

The first reason is a renewed resort to the so-called "literal" words of the statute. However, the Commissioner is unwilling to leave his position so bare, and so he adds a number of embellishments. For example, he dwells on the alleged "textual difficulties in making the words of the statute mean what petitioners would have them mean." (Resp. 15.) But at no point does he reveal the nature or extent of the supposed "difficulties."<sup>3</sup> He next suggests that the word "gain" gen-

<sup>3</sup> The Commissioner devotes some effort to establishing that the words "attributable to" relate to the constructed property. (Resp. 15.) The dispute here is over the nature of the "gain" on which the statute hinges. The Commissioner himself finally realizes this, and addresses himself to the meaning of "gain". (Resp. 16-18.)

erally has a single settled meaning throughout the Code. (Resp. 16.) Yet he also concedes that other words in the Code—like “income,” “gift,” and “property”—have a variable meaning in the light of “underlying statutory policy and the needs of a rational and workable tax structure.” (Resp. 18.) According to the Commissioner, then, the word “gain” is distinctly different from the word “income.” In fact, it is one of those rare words that has only one meaning or content. This Court,<sup>4</sup> as well as other courts,<sup>5</sup> has not found that “gain” is so simple and uniform in meaning as the Commissioner would now like to believe. Even where the Code specifically defines a word commonly used in its various provisions, it circumspectly adds that the definition applies only “where not otherwise distinctly expressed or manifestly incompatible with the intent thereof.” Int. Rev. Code of 1939, § 3797(a). The ultimate and controlling consideration always is the policy that a term was designed to express in its particular context. (Pet. 45-46, 67-68.) Cf. *Associated Telephone & Telegraph Co. v. United States*, 306 F. 2d 824, 832 (2d Cir. 1962), *cert. denied*, 371 U.S. 950 (1963), which resolves a question of interpretation quite differently from the decision below.

Apparently even the Commissioner realizes that a word like “gain” is susceptible to varying meanings,

<sup>4</sup> Compare the varying views in *Gray v. Darlington*, 15 Wall. 63 (1872); *Hays v. Gauley Mountain Coal Co.*, 247 U.S. 189 (1918); *Lynch v. Tarrish*, 247 U.S. 221 (1918); *Merchants' Loan & Trust Co. v. Smietanka*, 255 U.S. 509 (1921); and see discussion in Magill, *Taxable Income* 103 et seq. (rev. ed. 1945). See further the different views expressed in *James v. United States*, 366 U.S. 213 (1961); and Pet. 43.

<sup>5</sup> E.g., compare *M. F. Reddington Co. v. Commissioner*, 131 F. 2d 1014 (2d Cir. 1942), with *Sicanoff Veg. Oil Corp. v. Commissioner*, 251 F. 2d 764 (7th Cir. 1958).

too. Hence he falls back on the further observation that "in a statute articulated in such great detail as § 117(m)," no room is available "for the kind of extensive rewriting" which, in his view, the petitioners are seeking. And for good measure he quotes Judge Learned Hand as stating, in the well-known *Gregory* case, that "as the articulation of a statute increases, the room for interpretation must contract." (Resp. 18.) See *Helvering v. Gregory*, 69 F. 2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1934). We regret that the Commissioner did not continue to read more of Judge Hand's rewarding opinion, instead of merely satisfying himself with the few words quoted. For the point made by Judge Hand is precisely the point made by us here—as well as the very point made by the Commissioner himself in the *Gregory* case. That case involved the reorganization statutes, which are easily as articulate as section 117(m). The taxpayer, like the Commissioner here, argued that since those statutes were meticulously phrased, there was nothing to construe. See 27 B.T.A. 223, 225 (1932). Judge Hand answered as follows in behalf of the Commissioner's position: "It is quite true . . . that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create." Judge Hand went on to hold that the "purpose of the section is plain enough," and construed its words in the light of that purpose and "the underlying presumption." 69 F. 2d at 810-811. Our position here is exactly the same.

Moreover, the definition of a collapsible corporation in section 117(m) is hardly so unusually elaborate as the Commissioner suggests. It is a very typical provision of the Code, phrased in everyday English. See p. 56, *infra*. In terms of detail, it is not particularly different from the basic provisions on capital gains in section 117, which are thoughtfully construed in accordance with the purposes of Congress. (Pet. 22-26.) At any rate, it goes without saying that this Court is much more concerned with good sense, in response to those purposes, than the number of words in a statute. If we may borrow from the Commissioner, the demands of "underlying statutory policy and the needs of a rational and workable tax structure" (Resp. 18) control the meaning of section 117(m), just as they determine the content of other statutes.

In the end, the question before the Court is like the questions resolved in such cases as *Corn Products Co. v. Commissioner*, *supra*, and *Commissioner v. Lake*, *supra*, which also dealt with section 117. Is the profit realized by the petitioners the gain contemplated by the statute? See Pet. 24-25, 51. The only discernible difference is that the Commissioner uses one standard of construction for taxpayers and another for himself. However, we are sufficiently old-fashioned to believe that the Commissioner should not indulge in double standards. Taxpayers are entitled to more than such shifting criteria of right and wrong. And so we deem it appropriate to quote what the Commissioner himself successfully argued in those cases.

For that matter, in the *Corn Products* and *Lake* cases, the problem of construction was more involved because of the internal structure of section 117(a). That statute defines "capital assets" as "property

held by the taxpayer (whether or not connected with his trade or business)"—subject to several exceptions. The property sold in each case did not fall within any of the exceptions. Nevertheless the Commissioner contended that neither property was a capital asset. The following excerpts from his arguments nicely summarize the proper standard of construction for the Commissioner and taxpayers alike. In the *Corn Products* case the Commissioner emphasized that the decisive consideration is to avoid doing "violence to the basic purpose and scope of Section 117." The question always is "the kind of gain" involved. "As this Court has indicated, the capital gains provisions must be read in the light of their purpose and in the context of the pattern of the income tax law which taxes ordinary income at full rates and grants exceptional treatment to capital gains and losses." Brief for the Respondent, pp. 19, 21, 27.<sup>6</sup> In the *Lake* case the Commissioner similarly stated that "the statute must be interpreted and applied so as to effectuate the manifest purpose of Congress." And, he then added, "the statutory language is not to be interpreted literally or according to its usual meaning when to do so would thwart that purpose." Brief for the Petitioners, p. 26.<sup>7</sup> All these statements equally apply here, even

<sup>6</sup> The Commissioner also reasoned that the statutory treatment of capital gains must be "narrowly applied" because it is a special exception to the general rule. *Id.* at 19-21. But here he is arguing that a special provision designed to protect the integrity of that narrow exception should be broadly applied well beyond that specific purpose. See further Pet. 52.

<sup>7</sup> Another recent brief of the Commissioner is also well worth quoting for the principles that he normally applies in his own behalf: "This Court has . . . frequently relied upon legislative history even where it was arguable—as it is not here—that the statutory language was unambiguous." "Thus, the important part

though the Commissioner would now put them aside in pursuit of his double standard. When the application of the stated principles favors the Government, he lauds them as the decisive criteria of interpretation. When their application happens to favor the taxpayer, he decries them as a "plea for a judicial, rather than legislative, rescue." (Resp. 17.) And here, indeed, he is trying to use a double standard for construing the very same group of statutes—the capital gains provisions in section 117.

The Commissioner cites another item as a means of enhancing his view of section 117(m). Our interpretation, he states, would require a "highly specific and complex set of standards by which to determine the application of the statute." (Resp. 18.) Again he makes a mysterious observation without adding any informative details. It seems enough to say that there is nothing more complicated here than the usual task of applying legislative standards in specific contexts. Courts do this every day amid varying circumstances. Furthermore, the hearings and committee reports clearly indicate how section 117(m) is to be applied. Certainly, our interpretation—which is precisely the construction that Congress contemplated—does not raise any more problems than a case-by-case application of the *Corn Products* and *Lake* decisions. We can think of few decisions which have created more prob-

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which the legislative history plays in determining the meaning of a statute is now a firmly entrenched teaching of this Court." "To disregard the Committee reports in this case would invite unnecessary litigation with respect to many other provisions of the revenue laws, the terms of which are often clarified and explained by reference to the careful statements of the drafting and reporting committees." Brief for the Petitioner, pp. 18-20, in *Commissioner v. Bilder*, 369 U.S. 489 (1962).

lems of intelligent administration than various leading cases won by the Government—such as *Helvering v. Clifford*, 309 U.S. 331 (1940); *Helvering v. Horst*, 311 U.S. 112 (1940); and *Gregory v. Helvering*, *supra*. Hence it is somewhat amusing to see the Commissioner suddenly express acute concern over undue complexity—especially when it is non-existent.

The short of the matter is that the Commissioner is simply pleading for a wooden and "literal" interpretation of the statute. The odds and ends tacked on to the plea do not obscure its true nature. But this resort to "literalism" is mere question-begging. It is the venerable fallacy of one-word-one-meaning. (Pet. 40-41.) And it is also the very kind of construction that the Solicitor General has cogently criticized and deplored. Cox, *Judge Learned Hand and the Interpretation of Statutes*, 60 Harv. L. Rev. 370 (1947).

The Commissioner's next point is that our construction is at odds with the regulations, which apply section 117(m) where the gain is not a conversion of ordinary income from the property. (Resp. 19.) However, the regulations do not add anything to the merits of his position.

As a respected Treasury authority has written, interpretative regulations are "no more than the Department's construction of the Revenue Act. Apart from their binding effect upon the personnel of the Bureau of Internal Revenue, they do not as Regulations possess any authority." Such regulations "considered in their own right enjoy, as respects taxpayers, no greater authority as to the meaning of the statutory language interpreted than is possessed by the discussions in the tax services or legal periodicals." Whatever effect

they have is as an aid to construction "under the principles of statutory interpretation." *Surrey, The Scope and Effect of Treasury Regulations Under the Income, Estate, and Gift Taxes*, 88 U. of Pa. L. Rev. 556, 557-558 (1940). Here they are not entitled to any weight as such aid. The position taken by the regulations does not "embody the results of any specialized departmental knowledge or experience," or serve any administrative "convenience or purpose apart from compliance with the supposed command of the statute. There is thus a complete absence of those reasons which ordinarily lead courts to give persuasive force to an administrative construction and which justify their acceptance of it in preference to their own." *Haggar Co. v. Helvering*, 308 U.S. 389, 398 (1940). And, as for "compliance with the supposed command of the statute," the regulations are directly in the teeth of the statute as thoroughly illuminated by its legislative history. Cf. *Trust of Bingham v. Commissioner*, 325 U.S. 365 (1945).

There is also something else which the Commissioner naturally fails to mention—that the administrative practice of the Treasury has been conspicuously inconsistent. His present view of the statute contradicts his prior position taken shortly after the statute was

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\* The Solicitor General has properly stressed "a serious weakness" that administrative interpretations "sometimes have" their "partisanship"; and that this frailty is particularly true of Treasury interpretations. "Under many statutes the position of the public officer charged with administration but lacking power to decide is not, and is not supposed to be, wholly impartial. Treasury officials are collectors of revenue . . . ." Hence "for reasons of partisanship official rulings should be read with caution," and the partisanship "should be taken into account in determining the weight to be given such interpretations by the courts." Cox, *supra*, at 390-392. These thoughtful comments are particularly pertinent here. See p. 17, *infra*.

enacted. His present view, then, does not qualify as a contemporaneous expression of opinion or as a position consistently held. Cf. *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 16 (1932); *Estate of Sanford v. Commissioner*, 308 U.S. 39, 51-52 (1939). Our construction only reflects what the Treasury itself held before it decided to improve upon the statute and its policy. Section 117(m) was enacted on September 23, 1950. Regulations were not proposed until over two years had elapsed—on October 9, 1952. And then they were not promulgated until almost another half year had passed—on March 26, 1953.<sup>17</sup> Meanwhile, however, the Treasury had confidently ruled that profits realized with respect to FHA rental developments—profits that were not a conversion of ordinary income from the property—were capital gains. See *Hearings before the Senate Committee on Banking and Currency pursuant to S. Res. 229 (F. H. A. Investigation)*, 83d Cong., 2d Sess. 161, 3469 (1954). One of these rulings was issued on November 30, 1950—about two months after the enactment of section 117(m). For the convenience of the Court this ruling is set forth in Appendix A, *infra*, pp. 1a-2a.<sup>18</sup> As the ruling indicates, there is not the slightest suggestion that section 117(m) is in any way relevant. Nor does the matter end there. In a number of cases involving FHA rental developments, the Treasury systematically asserted deficiencies on grounds other than section 117(m). It was only later that it decided to switch over to that

<sup>17</sup> 17 Fed. Reg. 9014; T.D. 5999, C.B. 1953-1, 187.

<sup>18</sup> While taxpayers are not entitled to rely on private rulings not addressed to them, "such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws." *Hanover Bank v. Commissioner*, 369 U.S. 672, 686-687 (1962).

statute by altering its interpretation. See *Estate of Carl C. Myers*, 15 T.C.M. 750 (1956); *Thomas Wilson*, 25 T.C. 1058 (1956); *W. H. Weaver*, 25 T.C. 1067 (1956); *C. D. Spangler*, 32 T.C. 782 (1959), *aff'd*, 278 F.2d 665 (4th Cir. 1960), *cert. denied*, 364 U.S. 825 (1960).<sup>11</sup>

The Treasury's eventual change of position, it seems, was inspired by something quite different and distinct from an effort to abide by the statute. After section 117(m) was enacted, concern developed, within and without Congress, over various loans guaranteed under section 608 of the National Housing Act. It was found that in many cases loans had exceeded actual costs of construction. FHA developments acquired a stigma of sharp dealing and unjust enrichment. Evidently the Treasury decided to lend its aid in minimizing the resulting benefits to stockholders in such developments. Section 117(m) was chosen to do the job, and the benefits were subjected to that section, regardless of whether they constituted a conversion of ordinary income from the property into capital gain. In an effort to be helpful, the Commissioner improvised a rule of his own under alleged cover of the statute. In short,

<sup>11</sup> In the *Myers* case the Commissioner never switched over. In the *Wilson* case the deficiency was initially asserted under section 22(a). "At the hearing, for the first time," he "indicated that to support his determination he was relying on section 117(m) of the Internal Revenue Code of 1939." 25 T.C. at 1066. In the *Weaver* case the Commissioner also rested initially on section 22(a). He first shifted to section 117(m) in an amended answer. "The item of income in controversy" under his amended position "was not even mentioned in the original deficiency notice." 25 T.C. at 1080-1081, 1085. In the *Spangler* case the same pattern was repeated. The Commissioner first introduced section 117(m) into the case through an amended answer filed on November 13, 1957. 32 T.C. at 791.

he confused questions of taxation with problems of business ethics. Cf. *Lilly v. Commissioner*, 343 U.S. 90 (1952). But the question here is not whether profits realized on FHA developments were too large. The question is whether Congress enacted section 117(m) in order to tax such profits.

We believe that the course of administrative practice speaks for itself. But the Commissioner himself has nicely illustrated the basic interpretative inconsistency within which the Treasury is enmeshed. In Rev. Rul. 56-50, C.B. 1956-1, 174, 175-176, he declared that "the objective" of section 117(m) "was to prevent the successful use of a device for converting ordinary income into long-term capital gain through the medium of a corporation." Yet at the same time he assumed, for the purpose of the ruling, that profit realized on a sale of stock in a corporation operating a rental development is collapsible income—though the profit was not a conversion of ordinary income any more than it is here.<sup>12</sup> At the very least, administrative reasoning should make internal sense before it seeks judicial approval.<sup>13</sup> Cf. *Trust of Bingham v. Commissioner*, *supra*, at 376-377; and cases cited at p. 16, *supra*.

<sup>12</sup> In the present case the Commissioner has reversed the procedure. First he argues that a conversion of ordinary income into capital gain is unnecessary. And then he works hard to establish that there was such a conversion here—though he finally gives up. See p. 54, *infra*.

<sup>13</sup> The Commissioner notes, as a further point in favor of the regulations, that they are "intricate and complicated." (Resp. 19.) We are unaware of any doctrine that complexity enhances the authority of Treasury regulations. Moreover, the argument is rather peculiar here, since the Commissioner roundly condemns our own position on the ground of alleged complexity. See p. 13, *supra*. In any event, the intricacies of the regulations have nothing to do with the present question.

Furthermore, the sale in question was made while the Treasury was still satisfied with its original understanding of the statute. The regulations on which the Commissioner now relies were issued about two years after the transaction was consummated. Therefore, they should not be given any retroactive effect here, even if they were otherwise entitled to some weight. Cf. *Commissioner v. Goodwyn Crockery Co.*, 63-1 U.S.T.C. ¶9369 (6th Cir. 1963). This is not a case like *Helvering v. Reynolds*, 313 U.S. 428 (1941), where the prior administrative construction related to a predecessor statute. Here the original construction dealt with the very statute involved, and the sale was made while that construction was still in effect. Cf. Harlan, J., in *Massey Motors v. United States*, 364 U.S. 92, 118-120 (1960) (dissent).

The Commissioner also tries to score a few other points in behalf of his first argument. He refers to extensive litigation in regard to FHA developments, and states that "not until" the decision in *United States v. Ivey*, 294 F. 2d 799 (5th Cir. 1961), "was it ever suggested" that the statute does not apply to the type of transaction involved here. And then he adds: "The commentators, too, shared the universal assumption of the courts and litigants that the statute did not permit of interpretive relief even if it should operate, in a given case, to reach what would otherwise have been capital gain." Hence, the Commissioner concludes, it is not only the regulations, but "the established understanding of the courts and the tax bar, that petitioners must overcome." (Resp. 19-20.)

If an argument is known by the company it keeps, this strand of reasoning is rather revealing. To begin with, the so-called "assumption" was much less "uni-

versal" than the Commissioner seems to think. At the very outset the Treasury itself construed section 117-(m) as not applying to transactions like the petitioners'. Moreover, the Treasury's present position—that section 117(m) converts capital gain from property into ordinary income—was directly attacked in the Second Circuit and the Tax Court. See *Glickman v. Commissioner*, 256 U.S. 108 (2d Cir. 1958); *Carl B. Rechner*, 30 T.C. 186 (1958).<sup>14</sup> However, it seems unnecessary to pursue this matter further. Where the taxpayer cites a contrary line of lower court decisions, the Commissioner is considerably less impressed with the reasoning in which he now engages.<sup>15</sup> As the Court

<sup>14</sup> Although the Treasury's present construction was directly challenged in the *Glickman* case, the Second Circuit did not discuss the question. See Brief for Petitioners, pp. 39-41, in *Glickman v. Commissioner*, *supra*. In the *Rechner* case the Tax Court disposed of the issue by simply holding that the statute encompasses property held for use in trade or business. But this answer completely misses the issue. No one denies that section 117(m) includes such property. The issue, rather, is whether the profit realized on a disposition of the stock is the "gain" to which the statute is addressed—a conversion of the ordinary income from the property into capital gain—and whether the property was manufactured or constructed with a view to the realization of such a profit. See Pet. 72-76.

<sup>15</sup> Only four circuits—the Second, Third, Fourth, and Fifth—have considered the applicability of section 117(m) to sales of stock in corporations holding property for rental. Of these four, only two—the Second and Fifth—have discussed the question now before the Court—whether the section applies to sales that do not effect a conversion of ordinary income from the property into capital gain. And these two disagreed. It has been well noted that the course of lower court decisions "might have been quite different" if cases other than those involving FHA projects had first reached the courts. Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment*, 58 Col. L. Rev. 1146, 1178, n. 77 (1958). But as the Commissioner recognizes, there is no distinction in principle between the *Ivey* case, which did not involve an FHA project, and this case, which does. See Brief for Resp. on Pet. for Cert. 4.

has stated, "We do not expect Congress to make an affirmative move every time a lower court indulges in an erroneous interpretation. In short, the original language speaks louder than such judicial action." *Jones v. Liberty Glass Co.*, 332 U.S. 524, 533 (1947). And see *Higgins v. Smith*, 308 U.S. 473 (1940), where the Court held that the Government's interpretation was not precluded by decisions of four courts of appeals and a consistent line of decisions in the Tax Court. Otherwise, indeed, this Court's weighty responsibilities as ultimate arbiter would, in effect, be delegated to the lower courts.<sup>16</sup> Cf. *James v. United States*, *supra*, at 220-221.

Little more need be said about the weight attributed to commentators. As one of them has critically observed, "the basic purposes of the original enactment have been forgotten," and the "legislative purpose has been much distorted in the performance." The Treasury's construction has resulted in "converting into ordinary income what would be capital gain in the absence of the corporate form." Anthoine, *supra*, at 1176, 1178. At any rate, until now we had been unaware that the construction of tax statutes resolves itself into a matter of counting heads among commentators. Indeed, the tax bar, like other experts, is very often wrong. Such landmark cases as *Helvering v. Clifford*, *supra*; *Gregory v. Helvering*, *supra*; and *Higgins v. Smith*, *supra*, would

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<sup>16</sup> Cf. *F. W. Woolworth Co. v. United States*, 91 F. 2d 973, 976 (2d Cir. 1937), *cert. denied*, 302 U.S. 768 (1938): "To suppose that Congress must particularly correct each mistaken construction under penalty of incorporating it into the fabric of the statute appears to us unwarranted; our fiscal legislation is detailed and specific enough already." And see *Surrey*, *supra*, at 564.

never have been decided as they were, if the controlling standard of decision is the understanding of the tax bar.

The Commissioner finally turns to the 1958 amendment for additional help. Once more the reasoning is curious. While the Commissioner concedes that later legislative developments "provide little aid in interpreting an earlier statute," he promptly ignores the concession and attempts to find the desired aid. He dwells upon the theme that the "relief" provided by Congress in 1958 is "much more circumscribed than that sought from the Court," and that this "fact" is "surely relevant when what the Court is asked to do amounts, as here, not to 'interpretation' but to judicial 'correction' of an alleged statutory oversight." Then the Commissioner states: "And if nothing else, the complexity of the 1958 amendments reveals the immense difficulties inevitably encountered in implementing a 'what might have been' standard of liability of the sort petitioners ask this Court to create and define quite without statutory aid." (Resp. 21-22.)

These observations are essentially mere rhetoric. We are not asking the Court for "relief"; we are not asking it to "correct" an "oversight"; and we are not asking it to implement a standard of "what might have been." We are simply asking the Court to construe section 117(m) as the Treasury and Congress contemplated when the statute was enacted, and as the Treasury construed the statute before it changed its mind. And the required standard of application is clearly set forth and illustrated in the legislative hearings. That standard is no more "what might have been" than the standard applied in such cases as *Hort v. Commissioner*, 313 U.S. 28 (1941); and *Commissioner v. Lake, supra*. Cf. *Griffiths v. Commissioner*,

368 U.S. 355, 358 (1939); *Helvering v. Horst, supra*, at 116-118; *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 612-613 (1938). The question is whether the profit realized on the sale or exchange of stock is a deliberately contrived substitute for what is normally received as ordinary income from the property. (Pet. 24-25.) We cannot understand why the Commissioner should find it more difficult to apply section 117(m) than the *Lake* decision. In one case, as in the other, it is simply a matter of looking at the content of the underlying gain. The only difference between the two is that in one case the substitute for the ordinary income from the property is obtained through a transfer of an interest in the property; in the other case, through a sale or exchange of stock.

Apart from the rhetoric, there is little else in the Commissioner's observations on the 1958 amendment. Indeed, in his very effort—weak as it is—to derive aid from the amendment, he is directly violating the amendment itself. A special provision in the amendment states, in so many words, that in determining whether or not a corporation is collapsible, the fact that it "does not meet the requirements" of the amendment "shall not be taken into account;" and the determination "in the case of a corporation which does not meet such requirements shall be made as if" the amendment "had not been enacted." (Pet. 87.) Or, as the report of the Finance Committee states, the enactment of the amendment "will never result in causing a corporation to be classified as collapsible." (Pet. 85.) The Committee wisely anticipated, as this case shows, that the Commissioner might well try to use the amendment as a means of rationalizing retroactive implications in his favor. And so the Committee

squarely prohibited him from doing what he is now attempting. Here we have not only a later statute, but a later statute which specifically declares that no adverse inferences against taxpayers are to be drawn from it. The courts are instructed to construe the definition of a collapsible corporation as if there were no amendment. In the apt words of Professor Anthoine, the amendment was "intended as a shield, not a sword". Anthoine, *supra*, at 1181.

In short, if the Commissioner's present position has been wrong all along, Congress' expression of concern in 1958 did not make it right. Cf. *White v. Winchester Country Club*, 315 U.S. 32, 39 (1942). The fact that Congress dealt with only a segment of a problem "does not imply controlling acceptance by Congress" of the Treasury's current construction. *Helvering v. Hallock*, 309 U.S. 106, 120, n.7 (1940). Tax statutes are enacted amid a cross-current of pressures and counter-pressure exerted by the Treasury and taxpayers. As in many other such cases, the complex 1958 amendment evidently derived from a compromise between the Treasury and Congress, which felt that the legislative policy had been gravely misapplied. The net result was an *ad hoc* solution confined to the most pressing cases before Congress. See the illuminating analysis in Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted*, 70 Harv. L. Rev. 1145, 1161-1163 (1957). In submitting the amendment, the Finance Committee did not remotely approve the construction which prompted it. In fact, the Committee explicitly criticized the construction as inflicting an "unintended hardship" on taxpayers. It produces "exactly the opposite effect from that intended" by converting bona fide capital

gains into ordinary income. (Pet. 82-86.) The fate of that construction was left to the fair adjudication of the courts, in the light of the purposes which prompted the enactment of section 117(m). Finally, corrective tax statutes often turn out to be unnecessary after having been enacted to resolve doubts or foreclose undesirable consequences, reflected or threatened by pending controversies. See, e.g., *Burnet v. Guggenheim*, 288 U.S. 280, 283 (1933); *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312, 322 (1934); *United States v. Stewart*, 311 U.S. 60, 66-68 (1940); *Commissioner v. Estate of Holmes*, 326 U.S. 480, 487-488 (1940). Cf. *Higgins v. Smith, supra*, at 479-480. See also Pet. 87-89. As the Government argued in *Higgins v. Smith, supra*, amid cognate circumstances, "Indeed it would be most ironical if the solicitude of Congress in meeting an evil with particularity should be taken to have foreclosed consideration of doubts under existing law which might be resolved in accord with the law as enacted for the future." Brief for the Petitioner, p. 31.

## II. THE SECOND ARGUMENT

This argument now makes its appearance for the first time. Of course, a new argument is not necessarily a better one. Here it only serves to confirm again that the Commissioner is turning the statute upside down. In the words of the Finance Committee, he is trying to "convert what would otherwise be capital gain into ordinary income." (Pet. 83.)

The Commissioner's reasoning is simple. Having argued at some length that the statute applies, regardless of the nature of the gain involved, he now contends that any values realized through the construction of

property are inherently ordinary income. Therefore, as we further understand the reasoning, stock proceeds which reflect the same values are necessarily conversions of such ordinary income. As the Commissioner puts it, a gain realized on a sale of constructed property is "a gain of a fundamentally different character from the kind of long-term appreciation in value, due to changes in market conditions." On the basis of this observation he then concludes: "In § 117(m), Congress has simply made the judgment that such construction and manufacturing profits are in their 'nature' ordinary income, and ought to be taxed as such rather than be allowed to be 'converted' into capital gain through stock sales. That eminently sensible policy judgment provides a complete explanation both of the purpose and of the language of the statute. To confine the statute to its purpose of preventing the 'conversion' of ordinary income into capital gain, the Court need only apply it as written." (Resp. 9, 23.)

This argument illustrates what Dean Griswold describes as "thinking great thoughts about a tax problem" without the benefit of any relevant statute. Griswold, *Cases and Materials on Federal Taxation* 15 (3d ed. 1950). The various observations are wholly removed from the actual policies and legislation of Congress. The mere fact that the Commissioner may not like those policies does not make them less real. As the court below also recognized (R. 35-37), Congress' views in regard to constructed property are quite different from those now so freely attributed to it. If three individuals construct an apartment building and later sell it, the profit realized on the sale is ordinary income or capital gain, depending on whether the property is held primarily for sale to customers in

the ordinary course of their trade or business. If the property is so held, the profit is ordinary income. If it is not so held, the profit is capital gain. Int. Rev. Code of 1939, § 117(a)(1) and (j)(1). Again, if the same three individuals construct and own the building through a corporation, which later sells the building, the tax on the profit similarly turns on whether the corporation holds the property primarily for sale to customers in the ordinary course of its trade or business. In other words, the fact of construction by the taxpayers involved is completely immaterial. As even the Commissioner concedes, apart from artistic compositions and similar properties, section 117(a)(1) and (j)(1) does not make any distinction "between purchased and created property." (Resp. 30, n. 27.)<sup>17</sup> The answer hinges on the underlying nature of the gain, as determined by the nature of the holding.

The clear policy of Congress, then, is that profit realized on a sale of property constructed by the taxpayer, whether individual or corporate, is capital gain—as long as the property is not held primarily for sale to customers in the ordinary course of business. By the same token, there is no conversion of "ordinary income" into "capital gain," as Congress understands

<sup>17</sup> The Commissioner finds it "interesting to speculate" whether the courts are not beginning to recognize some difference in "problems" between "taxpayer-created properties" and "purchased properties." (Resp. 30, n. 27.) His speculations quietly ignore the relevant cases. It is hornbook law that the nature of a gain realized on a sale turns on the purpose for which the property was held in relation to the taxpayer's business—not on whether the property was constructed or purchased by him. See, e.g., *Victory Housing No. 2 v. Commissioner*, 205 F. 2d 371 (10th Cir. 1953); *McGah v. Commissioner*, 210 F. 2d 769 (9th Cir. 1954); *Goldberg v. Commissioner*, 223 F. 2d 709 (5th Cir. 1955); *Curtis Company v. Commissioner*, 232 F. 2d 167 (3d Cir. 1956).

these words, if the same profit is realized through a sale of stock rather than a sale of the property itself. The Commissioner is, in effect, arguing that in the exercise of an "eminently sensible policy judgment," Congress provided that a profit which is plainly a capital gain acquires "a fundamentally different character" if it happens to be realized through a sale of stock. And this "eminently sensible policy judgment" is then described as "a complete explanation" of what Congress has done. We respectfully submit that Congress is entitled to much more respect in the process of construing its statutes.

If any doubts remain, they should be fully removed by the legislative history of another provision in section 117—subsection (a)(1)(C), which is supplemented by subsection (j)(1)(C). Subsection (a)(1)(C) states that "capital assets" do not include "a copyright; a literary, musical, or artistic composition; or similar property"; held by "a taxpayer whose personal efforts created such property."<sup>18</sup> This subsection and subsection (m) of section 117 were enacted at the same time. And, as the committee reports indicate, they are in *pari materia* and must be closely construed together.

Subsection (a)(1)(C) originated in the Ways and Means Committee, and initially included patents as well as copyrights and other artistic compositions. The Committee explained that under the then existing law a basic line was drawn between professionals and amateurs who derived income from a sale of a book or an

<sup>18</sup> The subsection provides similarly with respect to a taxpayer whose basis for such property is determined by reference to the basis in the hands of "the person whose personal efforts created such property."

invention. The profit of the professional was ordinary income, "since the products of his work are held by him 'primarily for sale to customers in the ordinary course of his trade or business' and are, therefore, not treated as capital assets." In contrast, the profit of the amateur was capital gain if he held "his invention or book or other artistic work for 6 months," because it was "not held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. As a result the taxpayer receives long-term capital gains treatment on the product of his personal effort." The Committee concluded that "when a person writes a book or creates some other sort of artistic work or devises an invention with the idea of realizing income on it he should be treated as being in the trade or business of writing, creating, or inventing, regardless of whether the income from his personal efforts is realized through royalties or through outright sale, and regardless of the fact that this is the first time he may have engaged in such a trade or business." H.R. Rep. No. 2319, 81st Cong., 2d Sess. 54 (1950). The Finance Committee eliminated inventions from the amendment, and the subsection, as so revised, was approved in conference. Sen. Rep. No. 2375, 81st Cong., 2d Sess. 43 (1950); Conf. Rep. No. 3124, 81st Cong., 2d Sess. 27 (1950).

For present purposes we are concerned with the amendment only as it relates to the operation of section 117(m). In this respect the committee reports are particularly informative. Both reports note that the amendment denying capital gain treatment covers, not only copyrights, and literary, musical, or artistic compositions, but also "similar property." Such "similar property" includes "a radio program which

has been created by the personal efforts of the taxpayer." On the other hand, the reports pointedly state, "The interest of a sole proprietor in such a business enterprise as a photographic studio is not 'similar property' even though the value of the business may be largely attributable to the personal efforts of the sole proprietor." The reports then specifically indicate that the amendment and section 117(m) are interrelated provisions that work together. The amendment, they explain, does not cover "the situation in which the taxpayer contributes a copyright or similar property created through his personal efforts to a newly formed corporation in exchange for its stock and then sells the stock since such situation is dealt with" in section 117(m), added to the Code by the same bill. H.R. Rep. No. 2319, *supra*, at 92-93; Sen. Rep. No. 2375, *supra*, at 84. See also Reg. 111, § 29.117-1, as amended by T.D. 5881, C.B. 1952-1, 56, 57. Section 117(m), then, was designed to prevent the avoidance, through incorporation and a sale of stock, of the ordinary tax imposed on a sale of the property covered by the amendment.

Two conclusions readily emerge from this chapter of legislative history. First, except for copyrights and similar property within subsection (a)(1)(C), property produced and held by the taxpayer qualifies as a capital asset, and a profit realized on its sale is a capital gain—as long as the property is not held primarily for sale to customers in the ordinary course of business. The extent of the personal services contributed to the production of the property is immaterial. The reports expressly cite a photographic studio, where the appreciation realized on a sale is "largely attributable to the personal efforts" of the taxpayer. Even

a patent—which uniquely derives from individual ability and resourcefulness—qualifies as a capital asset. And so we need hardly add that a profit realized on a sale of a typical apartment building is *a fortiori* a capital gain, even though the success of the enterprise may be largely due to the personal efforts of the owners. We are only summarizing hornbook tax law. Everyday taxpayers sell business properties, not held for sale in ordinary course, to which they have devoted their energies and talents. And the gains realized in such transactions are uniformly taxed as capital gains.

Second, the committee reports explicitly coordinate section 117(m) with copyrights and similar property, as distinguished from other property to which the taxpayer may have contributed his personal efforts or skills. And they do so because the profit realized on a disposition of copyrights or similar property is taxed as ordinary income. Otherwise the taxpayer will be able to convert ordinary income into capital gain through a sale of stock instead of the copyright. But to apply section 117(m) similarly with respect to other properties would make nonsense out of the reports. A patent and a photographic studio are again apt illustrations. As we have seen, the Finance Committee insisted, and the Ways and Means Committee eventually agreed, that profit derived from a sale of a patent is a capital gain, if the patent is not held primarily for sale to customers in the ordinary course of business. Surely, the committees did not at the same time contemplate that if the invention were devised in a corporation, the profit on the sale of the stock would be ordinary income. Again, both committees emphasized, by way of example, that a photographic studio largely developed through the personal efforts of its owner is

a capital asset, and that a profit on its sale is a capital gain. Surely, the committees did not contemplate that if the taxpayer developed the same studio through a corporation, the same profit realized on a sale of stock would be ordinary income. And what the reports so plainly reveal applies no less to run-of-the-mine apartment buildings.

To restate our conclusion in the form of two questions, if profits realized on a sale of constructed property "are in their 'nature' ordinary income" (see p. 26, *supra*), then why are such profits taxed as capital gains if realized by the corporation itself or by individual owners on a direct sale of the property? And, second, if Congress set out to reach profits which are otherwise normally taxable as capital gains; then why did it make the application of section 117(m) turn on the purpose or motive with which the property was constructed? A tax avoidance statute carefully geared to purpose is necessarily concerned with attempted improprieties. As the Commissioner understands the section, Congress proscribed as tax avoidance a corporation used to construct property and realize a capital gain which Congress otherwise regards and taxes as a capital gain. See Pet. 61-63. And such an interpretation is deemed a faithful adherence to the purposes and policies of Congress.

### III. THE THIRD ARGUMENT

The final argument is another attempt to re-ration-  
alize the decision below. This new effort is adorned by  
vivid verbiage, which is supposed to suggest an insid-  
ious intrigue against the revenue. If an argument  
alone will not do, perhaps dramatic license will help.  
But all the colorful words do not obscure the mistakes  
and misconceptions on which the argument rests.

This case, the Commissioner states, "is an extreme and flagrant example of the very abuse at which the statute was directed: the conversion into capital gain of the normal profits generated by the manufacture, construction, or production of property." And, in an effort to be more persuasive, he also states that the conversion is "blatant" and "most blatant." (Resp. 9, 22, 25, 36-37.)<sup>10</sup> He then tries to justify his rhetoric by focusing on the profit derived from the sale of stock in Springfield. The petitioners—the argument runs—"were able two years later to dispose of it for \$683,500 for only one reason: by charging the corporation nothing for architectural, general contracting, and subcontracting services estimated to cost over \$700,000, they had created for the corporation buildings worth \$683,500 more than their actual cost. In short, petitioners contributed their services to create a valuable property for the corporation and then real-

<sup>10</sup> Now and then the Commissioner tries to derive some obscure significance from the fact that the petitioners paid only \$30 for their stock in each corporation. (Resp. 9, 14, 25.) We fail to understand the relevance of this item. Moreover, again the Commissioner is less than complete in stating the facts. First, the petitioners supplied the land on which the development was built. (A. 190, 192.) Second, they provided 99-year leaseholds for the two corporations. (A. 200, 215.) Third, the National Housing Act contemplated that construction costs would be largely financed through borrowed capital under a program of federal insurance. The very purpose of the Act was to encourage builders, like the petitioners, to construct apartment developments under such terms. The petitioners simply proceeded in accordance with this program as administered by the F.H.A. No additional equity capital was placed in the enterprise because no more was required. Both corporations had sufficient capital for their needs. The Commissioner seems to be under the impression that the larger the sum risked, the better the investment. In our system of private enterprise investors commonly embark upon financial ventures with borrowed funds. And they put in only so much of their own money as is necessary.

ized upon that value by selling their stock." If they had adequately charged for their services, "they would have ended up with construction profits of \$706,979, taxable to them as ordinary income." The proceeds of sale "resulted plainly and simply from the conversion of the value of their contributed construction services. In a word, they took out of the corporation in the form of proceeds from the sale of stock neither more nor less than what they put into it in the form of contributed services." (Resp. 9-10, 24-25.)<sup>29</sup>

The essence of this contention is clear. The Commissioner has seized on the phrase "conversion of ordinary income," which appears in the hearings and reports, to build an argument that has little to do with the meaning of the phrase as used there. As the hearings and reports make clear, the ordinary income with which section 117(m) is concerned is the ordinary income that normally flows from the constructed property. The abuse it seeks to prevent is the transformation of that income into capital gain. The Commissioner tries to sustain his position by isolating and quoting a fragment of legislative history. (Resp. 33.) In this detached fragment President Truman stated that actors had joined with producers in setting up collapsible corporations. (Pet. 27.) But as the legislative history fully indicates, the compensation that may or may not be paid to a particular stockholder is immaterial in determining whether a corporation is

<sup>29</sup> In his effort to dramatize, the Commissioner exaggerates. He implies that the petitioners went looking for a buyer. (Resp. 25.) In the spring of 1950—substantially after the development was completed—a number of brokers approached the petitioners, but they refused to negotiate. (A. 127-128.) The petitioners never listed the property with brokers. (A. 127-128, 169.) The negotiations which led to the sale were initiated by brokers on behalf of the purchasers. (A. 135, 136, 167, 243.)

collapsible. The critical vice of the collapsible corporation is the planned conversion of the ordinary income *from the property* into capital gain before the corporation itself realizes a substantial part of the ordinary income *from the property*. See *Hearings before the Committee on Ways and Means on Revenue Revision of 1950*, 81st Cong., 2d Sess. 70; and Pet. 28-35. None of the examples given in the hearings and reports evinces the least interest in whether the stockholders—be they producers or builders—are adequately compensated for their services to the corporation.<sup>21</sup> In every example there is the same single-minded emphasis on only one thing—the studied failure of the corporation to derive ordinary income from the property produced or constructed before the stockholders convert that income into capital gain. Otherwise the substantial legislative materials are a meaningless collection of words. Certainly, they make no sense if the Commissioner's present view of the statute is correct.<sup>22</sup>

<sup>21</sup> The President, in short, mentioned actors, as well as producers, not to define the nature of a collapsible corporation, but to indicate that actors, who normally do not own motion pictures, could also be given shares in such corporations as compensation for services. On the other hand, the nature of the collapsible corporation itself was repeatedly summarized as a device deliberately used to transform ordinary income from the constructed or manufactured property into capital gain. Of course, if an actor obtains stock as compensation for services, the value of the stock is immediately taxable as ordinary income. Reg. 111, § 29.22(a)-3. In any case, here the petitioners did not receive any stock for services. (A. 249.) Moreover, in 1950 Congress specifically dealt with the special kind of property, to which actors contribute their unique efforts, through subsection (a)(1)(C) of section 117, in conjunction with subsection (m). See pp. 28-31, *supra*.

<sup>22</sup> The Commissioner charges us with using some so-called "model" for determining when section 117(m) applies—"one that involves a particularly great restructuring of the transaction." (Resp. 10, 14-15, 26.) We are not seeking to "restructure" any-

What is so plainly shown by the legislative history is confirmed by the statute itself. Under section 117(m) no problem of collapsibility can arise unless the stock is sold or exchanged "prior to the realization by the corporation" itself "of a substantial part of the net income to be derived from" the property. And that net income is the ordinary business profit realizable by the corporation "in its normal business operations." (Pet. 65.) The compensation paid or not paid to stockholders is irrelevant. Clearly, if Congress had intended to define collapsibility in terms of a conversion of compensation, as distinguished from a conversion of ordinary income from the property, it would have said so. Nor do the regulations remotely include any such theory of conversion as the Commissioner is now espousing. The regulations state that whether a corporation is collapsible shall be determined "on the basis of all the facts and circumstances in each particular case." Reg. 111, § 29.117-11(d). But not one provision or example reflects the slightest concern with the adequacy or reasonableness of compensation received by stockholders.

All in all, the Commissioner's argument here is essentially the same as his second argument, though it is more elaborately stated. And hence it is enmeshed in the same difficulty. There was no conversion of

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thing. We are simply construing "gain" attributable to the constructed property as the Treasury and the tax committees contemplated. And we are merely applying the same norms that they used. See Pet. 27-38; see p. 13, *supra*. The Commissioner further observes that "persons using the corporate form" must "accept the tax consequences of their choice." (Resp. 32, n. 29.) We have no desire to quarrel with this generality, for there is no attempt here to disregard the corporate form. The question is how the profit realized on the sale of the stock is to be taxed. Compare section 115(g), relating to the taxation of disguised dividends.

"ordinary income into long-term capital gain through the medium of a corporation." See p. 18, *supra*. If the corporations had sold the development—or if the petitioners had individually owned, operated and sold it—the profit on the sale would have been a capital gain. The personal services of the petitioners, no matter how substantial, would be irrelevant. Whether they were paid or not would be equally irrelevant. In 1950 the tax committees squarely confirmed the basic policy to this effect, subject to one exception. See p. 28, *supra*.<sup>23</sup> But, as the Commissioner would have it, at the very time the committees confirmed this basic policy, they also provided that if the same profit is realized through a sale of stock, it is taxable as disguised compensation. Even the Commissioner is somewhat embarrassed by such strange incongruities. (Resp. 29.) For, in effect, he is converting capital gain into ordinary income because the enterprise happened to be incorporated and the petitioners sold stock instead of assets. And so he tries to supply a satisfactory explanation for the absurdity that he attributes to Congress. If the same profit, he states, is otherwise commonly realized and

<sup>23</sup> This one exception relates to copyrights, artistic compositions, and "similar property." But even gains realized on a sale of such assets are not taxed as compensation for services. They are taxed as gains realized on a sale of property held for sale to customers in the ordinary course of business. See H.R. Rep. No. 2319, *supra*, at 54. Cf. G.C.M. 236, C.B. VI-2, 27 (1927); Rev. Rul. 55-636, C.B. 1955-2, 17; Tax Guide for U. S. Citizens Abroad, § 10.09 (I.R.S. 1960 ed.). These administrative rulings hold that the proceeds of a sale of a book are not compensation for services, but payments for property. Therefore, such proceeds do not qualify as compensation for purposes of an earned income credit, the retirement income credit, and the exemption for income earned abroad. As the Tax Guide succinctly puts it, the sales proceeds "are not earned income any more than proceeds from the sale of the writer's car or any other item of property would be." See also Reg. 111, § 29.22(a)-9.

taxed as a capital gain, "it proves only that loopholes remain, not that the Court should reopen the one Congress closed." (Resp. 10.)

In other words, the Commissioner blandly dismisses the basic policy, which the tax committees so deliberately confirmed in 1950, as "loopholes." Or, to put it more simply, he is creating his own tax policy for the occasion. At the very least, a loophole is a means of escaping some tax which is otherwise imposed on the taxpayer. But here Congress, after full reflection, decided that the tax otherwise justly due is a capital gains tax. And it ill behooves the Commissioner, in the process of enforcing the tax laws, to dismiss Congress' deliberate choice of policy as "loopholes." Cf. Pet. 96. The Commissioner's loose talk about "loopholes" illustrates the famous adage of Humpty-Dumpty: "When *I* use a word, it means just what *I* choose it to mean—neither more nor less." However, the question here is what the word means to Congress, not what it means to the Commissioner. And his attempted explanation only confirms again what is already sufficiently clear—that he is at a loss to rationalize his new theory. Various rules of construction "come down to us from sources that were hostile toward the legislative process itself and thought it generally wise to restrict the operation of an act to its narrowest permissible compass." *S.E.C. v. Joiner Leasing Corp.*, 320 U.S. 344, 350 (1943). But one can be equally hostile by being overly generous with Congress' words while ignoring its policies. The Commissioner seems more sensitive to such matters when taxpayers try to read statutes in this fashion. Cf. *Corn Products Co. v. Commissioner*, *supra*; *Commissioner v. Lake*, *supra*; Pet. 23-26, 50-51.

We have by no means exhausted the errors on which this third argument rests. The Commissioner proceeds on the premise that the moneys realized on the sale derived solely from the petitioners' failure to charge for their services. To quote him once more, "In a word, they took out of the corporation in the form of proceeds from the sale of stock neither more nor less than what they put into it in the form of contributed services." If they had been paid, he apparently reasons, the proceeds of the sale would have been *pro tanto* less.

These generalities reflect a good measure of confusion. The value of property at a given time is not determined by the services originally contributed to its construction. It depends on something distinctly different—"the relative intensity of the social desire for it at that time, expressed in the money that it would bring in the market." *Ithaca Trust Co. v. United States*, 279 U.S. 151, 155 (1929). Whether property is constructed or purchased, its value, from time to time, is due to changes in market conditions. See p. 26, *supra*.

Again, the Commissioner ~~has~~ confused the petitioners' services with the ~~savings~~ realized on construction. The F.H.A. estimated Springfield's cost of construction at \$4,002,959. This sum "was the same in amount as the total of the items of cost for landscape work, utilities, apartments and garages shown therefor in its project analysis." In addition, the construction contract "contained schedules showing an allocation of the said \$4,002,959 to the various units of the project to be constructed according to the nature of the work and the materials to be used." This sum did not include any amount for builder's and architect's fees, for the petitioners had waived such fees. (A. 201-203.)

Hence the construction partnership of the petitioners performed the work under a simple reimbursement arrangement. Springfield paid the partnership exactly what it expended for labor and materials. (A.120-121.) The Internal Revenue Service examined the partnership's 1949 return reflecting this arrangement. Gross receipts were shown in the same amount as costs.<sup>6</sup> The Service accepted the return without change. (A. 205.)

"The F.H.A. project analyses estimated replacement cost of the proposed housing projects for a typical builder, rather than for the most or the least efficient builder." *W. H. Weaver*, 25 T.C. 1067, 1075 (1956). As it turned out, the petitioners were more efficient than the typical builder. However, the savings were not monies to which they were entitled for services, since they had duly waived the fees for their services. Indeed, if they had helped themselves to the savings in payment for their services, they would have violated their arrangement with the F.H.A. Evidently, the Commissioner is now exercised because they failed to break their commitment to another executive agency.

The Commissioner's position is no better when we focus on the builder's and architect's fees which are so prominently displayed in the argument. For the Commissioner has plainly misunderstood the role of these fees in the loan arrangements of the F.H.A. He might have found his broad assertions less persuasive if he had been more attentive to the facts. The proceeds from the sale of the stock would have been exactly the same if the fees had been paid. Moreover, there was a very good business reason for waiving the fees.

Under section 608 of the National Housing Act the insured mortgage loan could not exceed 90 percent of

the amount which the F.H.A. estimated as the cost of the development.<sup>24</sup> An application for mortgage insurance was made on a special form provided by the F.H.A. (A. 188-189.) This form directed the applicant to state the total estimated requirements for the development, including the estimated cost of construction, builder's and architect's fees, and carrying charges. (A. 188, 191-192.) The difference between the total estimated requirements and the amount of the mortgage loan was to be supplied by the mortgagor. (A. 189, 191-192.) In accordance with its own estimates and calculations, as set forth in its project analysis (A. 57, 63)<sup>25</sup>, the F.H.A. then issued a commitment for insurance. (A. 192-193, 197, 209.) Both the project analysis and commitment required the mortgagor to deposit the amount needed, over and above the mortgage loan, to complete the project. (A. 197, 213.) This amount was the difference between the mortgage loan and the F.H.A.'s estimate of the total cash necessary for completion, including the builder's and architect's fees. (A. 197, 213.) However, the commitment advised the applicant that this amount could be reduced by the sum of the builder's and architect's fees which were not to be paid in cash. (A. 197, 213.)

<sup>24</sup> 56 Stat. 303 (1942), 12 U.S.C. § 1743 (1946 ed.), as amended by 60 Stat. 214 (1946), 12 U.S.C. § 1743 (1952 ed.), and 61 Stat. 945 (1947), 12 U.S.C. § 1738 (1952 ed.).

<sup>25</sup> We respectfully draw the Court's attention to a printer's error which reversed the fourth pages (A. 60, A. 66) of the project analyses of Springfield and Hill.

In the case of Springfield the F.H.A. computed the total estimated requirements at \$4,683,704, including \$410,303 for builder's and architect's fees. The estimated cost, not including anything for such fees, was \$4,273,401. The mortgage loan was \$4,174,800, or \$98,601 less than the estimated cost after eliminating the fees. (A. 194.) In the case of Hill the F.H.A. computed the total estimated requirements at \$2,162,100, including \$189,438 for builder's and architect's fees. The estimated cost, not including anything for such fees, was \$1,972,662. The mortgage loan was \$1,926,800, or \$45,862 less than the estimated cost after eliminating the fees. (A. 210.) As these figures show, the mortgage loan plus the cash to be supplied by the petitioners precisely equalled the estimated cost of construction, after eliminating the builder's and architect's fees. If the corporations' actual costs had been the same as the F.H.A.'s estimated costs, not including the fees, there would not have been any residual mortgage proceeds. A balance was left because the eventual costs were less than the F.H.A. had projected on the basis of its own analyses.<sup>26</sup>

The petitioners waived the fees because it was elementary business sense to do so under the F.H.A. program. For under the requirements of that program

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<sup>26</sup> The Tax Court made calculations designed to show what the mortgage loans would have been if the builder's and architect's fees had not been initially included in the total estimated requirements for the development. (A. 194, n. 3, 210, n. 9.) These computations are completely academic. The fees were included because the F.H.A. required their inclusion under its established method of computing the mortgage loan. Obviously, unless the fees were included in the estimated costs, it made no sense to allow the applicant to reduce the excess over and above the mortgage loan by the amount of the fees, where the fees were not to be paid in cash.

they could not charge for their services unless they put up their own money to pay themselves. As the Tax Court found, if they had not waived the fees, they would have had to raise and contribute the sum of the fees to the project. This further amount would have been about \$600,000—\$410,303 for Springfield and \$189,438 for Hill, or \$599,741 altogether—which the petitioner's would have had to furnish to the corporations. (A. 204, 218.) Obviously, it was senseless to incur so huge a financial burden merely to pay themselves, if the burden was unnecessary. And the F.H.A. made it unnecessary by authorizing the waivers. (A. 197, 213. See also A. 111-113.) For that matter, any attempt to impose such a burden would have been absurdly self-defeating. The very purpose of the F.H.A.'s program was to encourage and expedite the construction of rental housing by minimizing the capital required of builders.

Now let us assume that the fees had not been waived. The petitioners would have had to raise the enormous sum of \$600,000 for contribution to the corporations. The same \$600,000 would then have been paid over to them in prior years as builder's and architect's fees. And the net result would be that the underlying property sold would be exactly the same as that actually sold in 1950. In a word, the value of what they sold was completely unaffected by the waiver of the fees.<sup>27</sup> Hence it is highly imaginative to say that the proceeds of the sale were attributable to the waiver of the fees.

<sup>27</sup> The waived fees bore no relationship to the stock holdings. Petitioner Braunstein would have received the entire amount of architect's fees, which exceeded the builder's fees, and would have shared equally in the builder's fees. (A. 198, 203, 205, 214.) Nor did the waived fees bear any relationship to the respective services. (A. 107, 126, 137-148.)

In his haste to contrive a new argument at this late stage, the Commissioner is equally oblivious to other facts. Through their services, the Commissioner asserts, the petitioners were able "to convert the 'savings' into an increase in the value of their equity" in the development—that is, "by creating" structures "presumably" worth considerably "more than they cost (and, hence, more than the mortgage indebtedness to which they were subject)." The Commissioner then reasons that the petitioners realized this "increase in the value of their equity," over and above the cost and mortgage indebtedness, through the proceeds of the sale. (Resp. 24-25.) The Commissioner freely forgets what he well remembers elsewhere in his brief. (Resp. 6-7.) A large part of the proceeds—\$555,000 out of about \$950,000—did not in any way reflect the market value of the buildings. It simply represented the accumulated cash on hand in the two corporations.

At the time of the sales negotiations the corporations had substantial amounts of cash. This cash consisted of the residual mortgage proceeds and accumulated rental income. The rental income had been fully offset on the corporate returns by deductions for depreciation, and additional deductions for interest and taxes, incurred as a cost of the development. (R. 1-2, 27; A. 44, 45, 224-226, 239-241.) The purchasers insisted, as part of the terms of sale, that the corporations distribute all but nominal amounts of cash to the petitioners. (Pet. 5.) Pursuant to the agreement of sale Springfield accordingly distributed \$410,000, and Hill \$145,000, or a total of \$555,000. Cf. *Steel Improvement & Forge Co. v. Commissioner*, 63-1 U.S.T.C. ¶9318 (6th Cir. 1963). This large share of the sales proceeds, then, represented a partial recovery of the

cost of the development and a portion of the mortgage indebtedness. Hence even under the Commissioner's newly discovered theory of "gain" attributable to the property—the "conversion" of "contributed services"—the \$555,000 cannot be made to qualify as a so-called "increase" in equity in the buildings beyond their cost and "the mortgage indebtedness to which they were subject."

The Commissioner disregards still another matter in the pursuit of his argument. According to his newly devised theory, the profit on the sale is "gain attributable to" the constructed property within section 117(m), because the petitioners did not charge the corporation "for architectural, general contracting, and subcontracting services." (Resp. 9-10.) The proceeds are deemed a conversion of ordinary income imputed to these services. Even if this far-fetched notion were for some reason correct, the corporations would not be collapsible. Under section 117(m) it is not enough that the shareholders realize, through the sale of their stock, the "gain attributable to" the constructed property. In addition, the corporation must be used for the construction of property "with a view to" the realization of that gain. (Pet. 20-21.)

As the Commissioner agrees, the significant phrase "with a view to" means "calculating upon or contemplating as a desired result." (Pet. 61-62.) The realization of the gain, then, must have been planned or contemplated. (Resp. 2, 8, 12; Brief for Resp. on Pet. for Cert. 2, 4-5). "Contemplation," this Court has held, is not some "general expectation" that "all entertain. It must be a particular concern, giving rise to a definite motive." *United States v. Wells*, 283 U.S. 102, 115 (1931). Therefore, under the Commissioner's

newly conceived theory—even if it were otherwise tenable—the corporations were not collapsible unless the fees were waived for the specific purpose of later realizing the gain now imputed to the fees. For “a deed is not done with intent to produce a consequence unless that consequence is the aim of the deed,” *Abrams v. United States*, 250 U.S. 616, 627 (1919) (dissent). But as the evidence and findings plainly show, the waiver was not remotely prompted by any such purpose. See pp. 42-43, *supra*. The fees were waived because of genuine business considerations.

The story is no different with regard to the alleged conversion of ordinary income which the Commissioner imputes to the “subcontracting services.” The items involved are plumbing, heating, and carpentry. Here, also, the Commissioner has paid no attention to the evidence and findings in his zealous pursuit of his new theory. On prior F.H.A. projects the petitioners had hired contractors to do the plumbing and heating work. (A. 227.) In estimating the costs for Springfield and Hill the petitioners had assumed that they would do the same. (A. 227.) They had similarly assumed that the carpentry would be handled by a contractor or contractors. (A. 227.) In accordance with these plans the petitioners solicited bids from plumbing and carpentry contractors. (A. 227.) They finally considered the bids too high, and decided to proceed without contractors. (A. 227.) The carpentry work was handled by an employee who had served as their superintendent for many years. (A. 227.) The plumbing and heating work was supervised by a master plumber. (A. 118, 227.) As a result, the Tax Court found, there were “savings which the petitioners had not expected at the outset.” (A. 227-228.) The car-

pantry work was about \$80,000 less than originally estimated, and the plumbing and heating work about \$85,000 less. (A. 227.) These savings had nothing to do with any "blatant" plan or scheme to realize some later profit. They were prompted by normal commonsense business reasons.

In a final effort to justify his third argument, the Commissioner turns to the motion picture industry. "The basic abuse" in the movie industry, he states, was "the conversion of the values in producing the movie through the stockholders' contributed services into capital gain." (Resp. 34.) This statement is plainly wrong. As the extensive legislative history shows, the abuse was that the stockholders realized, as a capital gain, the ordinary, everyday profits from the picture which are normally realized, either individually, or through the corporation, as ordinary income. See also pp. 2-3, *supra*. And as the same history further shows, this conversion was effected through a liquidation of the corporation. The value of the picture was reported as a capital gain on the liquidation, and the normal rental income received by the stockholders, rather than the corporation, was cancelled out by amortizing the value of the film against that income. (Pet. 72.)

The Commissioner asserts that apartment buildings are just like motion pictures, except for a minor difference in "the locale and the cast of characters." (Resp. 34.) And then he applies this generality to the present case. Yet, despite this display of confidence, the legislative history does not include the slightest reference to apartment buildings. While the hearings and reports express concern over tax avoidance in the construction industry, the concern is solely with builders who construct houses for sale to customers in

the ordinary course of their business. (Pet. 72.) There is no mention whatever of builders who construct apartment developments for rental, as distinguished from sale in the ordinary course of business. The difference in attitude, we believe, is easily explained. If a builder who owns and operates such an apartment development eventually sells it, the profit is a capital gain. Similarly, if he owns and operates the building through a corporation which later sells it, the profit is also a capital gain. And so there is no reason to be disturbed over a sale of the stock instead of the property. The sale does not convert ordinary income from the property into capital gain.

Of course, as the Commissioner notes, a builder of an apartment development might try to emulate a movie producer by liquidating his corporation and then writing off the value of the building against his rental income as continuing owner of the property. But, as the Commissioner fails to add, the tax incentives for the builder are hardly comparable to those of the producer. In the case of the movie the rental income is received in a very short time, and all the value realized as a capital gain on the liquidation is quickly written off against that income. The period of amortization ranges between one and two years. Even if the period runs beyond one year, almost all the income and write-off falls within the first year.<sup>28</sup> On the other hand, in the case of the apartment building the period of write-off is far longer. Until recently the Commissioner held that the useful life of an apartment building for purposes of depreciation varies between  $33\frac{1}{3}$  and 40

<sup>28</sup> Tannenbaum, *Amortization of Motion Pictures*, 1948 Proc. U.S.C. Tax Inst. 345, 347-348 (1949).

years.<sup>29</sup> Now he fixes the useful life at 40 years.<sup>30</sup> The attempted conversion of continuing rental receipts into capital gain through a corporate liquidation is by no means as attractive as the Commissioner assumes. The stockholder must immediately pay a large capital gains tax, and the gain is not quickly written off against rentals as in the movie industry.

In any event, it makes no difference even if such a conversion were more attractive. In the first place, the profit realized here on the sale was not a conversion of ordinary business profit from the development into capital gain. The question is not whether the petitioners sold or exchanged their stock at a profit, but whether the disposition enabled them to realize the "gain" that section 117(m) taxes as ordinary income in accordance with its true economic content. Here there was no such "gain." There was no attempt to transmute continuing rental receipts into capital gain.<sup>31</sup> In the second place, here the petitioners were not even able to effect such a conversion through a liquidation—even if they had wanted to do so. For the Administrative Rules of the F.H.A. prohibited them from liqui-

<sup>29</sup> Bulletin F, Tables of Useful Lives of Depreciable Property, I.R.S. Pub. No. 173, p. 7 (1955).

<sup>30</sup> Depreciation Guidelines and Rules, I.R.S. Pub. No. 456, p. 12 (1962).

<sup>31</sup> The Commissioner states: "The statute makes nothing turn on whether the corporation is liquidated or the stock sold." (Resp. 34, n. 31.) This is a delusive half-truth, which ignores the committee reports. Section 117(m) includes sales of stock as well as liquidations in order to reach those cases where a sale raises "the same tax questions" as a liquidation. (Pet. 35, 73.) And those "same tax questions" are the realization of the ordinary income of the property as a capital gain. Nothing turns on a liquidation or sale as such—but on whether a liquidation or sale produces, with the required "view" or purpose, the particular profit with which the statute is concerned. (Pet. 71-76.)

dating the corporations and operating the development as individuals. Administrative Rules of the F.H.A. for War Rental Housing Insurance, §§ 580.26, 580.29. See Appendix B, *infra*, p. 3a. In brief, the petitioners could not realize the ordinary income from the development as a capital gain, because the sole means of effecting such a conversion was closed to them. They could not in any way engage in the tax avoidance which the statute set out to prevent.<sup>32</sup>

In fact, the results of the Commissioner's construction are so unreasonable as to raise a constitutional question of irrational discrimination under the Fifth Amendment. Unlike the Fourteenth Amendment, the Fifth Amendment does not contain an equal protection clause. "But the concepts of equal protection and due process, both stemming from our American ideal of fairness, are not mutually exclusive." And "as this Court has recognized, discrimination may be so unjustifiable as to be violative of due process." *Belling v. Sharpe*, 347 U.S. 498, 499 (1954). See *Heiner v. Donnan*, 285 U.S. 312, 326, 331 (1932); *Tyler v. United States*, 281 U.S. 497, 504 (1930). Limitations like the Fifth Amendment "are admonitions of fair dealing, whose disregard the courts will correct, if extreme and glaring." *Cohan v. Commissioner*, 39 F. 2d 540, 545 (2d Cir. 1930).

The Commissioner's interpretation is so capricious as to violate the basic standard of fairness implicit in due process. Here, according to the Commissioner,

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<sup>32</sup> The Commissioner notes that the F.H.A. required the petitioners to operate through a corporation. (Resp. 26, n. 25.) This only emphasizes all the more that section 117(m) should not be construed so as to penalize taxpayers for using a corporation—especially where they were fully barred from converting the ordinary income from the property into capital gain.

Congress has deliberately and arbitrarily distinguished between doing business as an individual and doing business through a corporation. The same profit is taxable as capital gain in one case and ordinary income in the other. And again, according to the Commissioner, even in the case of a corporation Congress has deliberately and arbitrarily distinguished between a sale of stock and a sale of the underlying assets. The Commissioner's construction is particularly irrational here because the petitioners had no choice in the matter. They had to do business through a corporation. See, *DuPont v. Commissioner*, 289 U.S. 685, 688 (1933). The admonition of fair dealing in the Fifth Amendment reinforces our view that section 117(m) should be sensibly construed.

The Commissioner tries to make something out of the basis of the property to the purchaser. He observes that when shareholders sell their stock in a corporation holding an apartment development, the buyer can liquidate the corporation and so obtain a higher basis for depreciation—namely, his purchase price for the stock. As a result, the purchaser can depreciate his higher basis, rather than the lower basis of the corporation, against the rental receipts. (Resp. 35.) We are at a loss to understand what this impeccable observation contributes to the present case. If builders own, operate, and sell an apartment development as individuals, the buyer also has a stepped-up basis for depreciation. Again, if they own it through a corporation and the corporation itself sells the development, the buyer similarly has a stepped-up basis. The sale of the stock, followed by a liquidation, does not in any way change the situation. Moreover, section 117(m) is not concerned with the basis of the property to the

purchaser. Its one and only concern is the nature of the profit realized by the seller.

But, more important, the Commissioner's observation on basis has a strange ring here. For here the buyers did not even obtain a stepped-up basis after the sale. As the Tax Court found, "Springfield and Hill continued as owners" of the development. (R. 18.) Therefore, the depreciation deductions against the income from the property continued to be computed on the original lower costs of construction incurred by the corporations. Furthermore, the controlling Rules of the F.H.A. also barred the purchasers from liquidating the corporations. See p. 49, *supra*. On the other hand, if the petitioners had owned and sold the development as individuals, or if the corporations had sold the development, the depreciation deductions would have been higher because they would have been based on the higher purchase price. To summarize the matter, the rental income subject to tax after the sale was larger than it would have been if the petitioners or the corporations had directly sold the assets. In view of all the talk of tax avoidance, we can well understand the Commissioner's failure to so advise the Court. Instead of losing revenue, the Government actually gained revenue.

The Commissioner complains that if our position is correct, then movie producers can continue to convert ordinary income from films into capital gain by regularly selling their stock instead of liquidating their corporations. (Pet. 35.) This conclusion does not in the least follow. In fact, a few observations discreetly placed in a footnote reveal that the Commissioner himself is uncomfortably aware that he has overstated his argument. (Resp. 36, n. 33.) The answer

is provided by subsection (a)(1)(C) of section 117, which was enacted at the same time as subsection (m). See p. 28, *supra*. Under subsection (a)(1)(C) a motion picture sold by those whose efforts produced it would not qualify as a capital asset. Therefore, the income realized on a direct sale of the picture would be ordinary income. From a tax standpoint such property is deemed property held primarily for sale to customers in the ordinary course of business.<sup>33</sup> By the same token, if the same taxpayers sought to realize the same profit by production through a corporation and a quick sale of its stock, the profit would be "gain attributable to such property" within section 117(m). For the profit would be an attempted conversion of ordinary income from the property into capital gain.<sup>34</sup> The Commissioner attempts to sidestep the interrelationship of the two subsections by saying: "Nothing in the history, however, suggests that Congress' purpose in § 117(m) to proscribe the corporate abuse typified by the movie example was derived from, or dependent upon the amendments to the 'capital asset' definition." (Resp. 36, n. 33.) However, the committee reports clearly indicate the close relationship of the two—that subsections (a)(1)(C) and (m) are to be applied together toward the same common end. See pp. 29-31, *supra*.<sup>35</sup>

<sup>33</sup> The regulations do not specifically refer to motion pictures. However, they include within section 117(a)(1)(C), by way of example, "a radio program" and "a theatrical production." Reg. 111, § 29.117-1, *supra*.

<sup>34</sup> The situation would be akin to the construction of homes for sale to customers in the ordinary course of business. (Pet. 30, 33-35, 72-74.)

<sup>35</sup> We cannot understand why the Commissioner is particularly disturbed over motion pictures, quite apart from section 117(a)(1)(C). The Commissioner has held that profit realized by a pro-

Indeed, when all the smoke clears away at the end, it turns out that the Commissioner's repeated talk of contributed services is quite irrelevant. In the Commissioner's own words of admission, "it is important to reemphasize what is of the essence and what is not." It is enough that the corporation has simply engaged in the "manufacture, construction, or production of property." Again, in the Commissioner's words, "the specific identity of the factors primarily responsible for the values created in those processes (capital, labor, know-how, sound market analysis, or whatever) is ultimately immaterial." The statute "reaches all gains 'attributable to the property so manufactured, constructed, or produced' regardless of whether they represent only the normal profits of manufacturing and construction (the values added simply by combining the necessary factors of production to create an economically useful product)." "The surest guide to the intended scope of the statute is its own terms," and what "should control, quite simply," is that the corporation was used for construction. (Resp. 37.) The various words on contributed services, then, are mere diversionary observations. Or, perhaps, they are only

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due on a sale of motion picture films is ordinary income because, given the special going market for films, they are usually held for sale to customers in the ordinary course of business. Rev. Rul. 62-141, I.R.B. 1962-35,9. It follows, then, that if stockholders sought to realize the same profit from the films through a sale of stock, they would realize precisely the gain encompassed by the collapsible statute. In the same ruling the Commissioner concedes that there may be some cases, depending on the particular circumstances, where a producer sells a film not held for sale to customers in the ordinary course of business. If the profit in such cases is a capital gain, then there is no conversion of ordinary income from the film into capital gain if stock is sold instead of the film. The Government is not being deprived of any revenue, and the collapsible statute should not apply.

rhetorical flourishes designed "to beautify what is disagreeable to the sufferers." *Tyson & Bro. v. Banton*, 273 U.S. 418, 446 (1927) (dissent). Under the Commissioner's understanding of the statute, as it frankly emerges at the end, any profit realized upon constructed property falls within section 117(m). And any such profit, he insists, necessarily constitutes a "conversion of ordinary income into capital gain." (Resp. 37-38.)

### CONCLUSION

Subsection (m) of section 117 is a segment of a comprehensive legislative scheme on the subject of capital gains. (Pet. 22.) And so the question here is precisely the same as the question commonly asked in applying section 117. Is the receipt involved the kind of profit to which the particular provision was addressed? (Pet. 23-26.) "We can best reach the meaning here, as always, by recourse to the underlying purpose" of the statute. *Borella v. Borden Co.*, 145 F. 2d 63, 64 (2d Cir. 1944), *aff'd*, 325 U.S. 679 (1945). And in implementing that purpose, "we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy." *Mastro Plastics v. N.L.R.B.*, 350 U.S. 270, 285 (1956). Insofar as we can tell, amid the various elements of error and confusion in his brief, the Commissioner agrees with these basic principles. He prominently protests that he, too, firmly believes that statutes should be read so as "to carry out the discovered purposes of Congress." And, along the same lines, he emphasizes that "absurd results" should be meticulously shunned, and a determined effort always made "to produce a rational, sensible structure." See p. 7, *supra*. Having made his professions of faith, the Commissioner rapidly forgets what he has said.

We have here a statute framed largely in colloquial language. But "the colloquial words of a statute have not the fixed and artificial content of scientific symbols; they have a penumbra, a dim fringe, a connotation, for they express an attitude of will, into which it is our duty to penetrate and which we must enforce ungrudgingly when we can ascertain it, regardless of imprecision in its expression." *Commissioner v. Ickelheimer*, 132 F. 2d 660, 662 (2d Cir. 1943) (dissent).<sup>38</sup> See also *Universal Camera Corp. v. Labor Board*, 340 U.S. 474, 489 (1951). Here the legislative purpose to be ungrudgingly enforced is plainly articulated in the legislative hearings and reports. The one and only problem with which section 117(m) is concerned is the studied attempt to realize the ordinary income from constructed property as a capital gain by means of incorporation and a sale or exchange of stock. In short, it is concerned with tax avoidance. There has been no such realization or avoidance here. The incorporation and sale have not enabled any ordinary income to escape the normal tax that would otherwise be due. In fact, the Commissioner is collecting more tax than would have been due if the petitioners had owned and sold the property as individuals. See pp. 51-52, *supra*. To construe the statute as the Commissioner does is to produce the very "absurd results" which, at least formally, he deplores. For as he would apply the statute, capital gain is converted into ordinary income. Section 117(m) is turned into a penal levy against those who realize bona fide capital gains through a sale of stock instead of the underlying property.

Throughout his brief the Commissioner has noticeably refrained from trying to explain why Congress

<sup>38</sup> This dissent was later sustained in *McWilliams v. Commissioner*, 331 U.S. 694 (1947).

should have desired or imposed such a result. The Court of Appeals itself indicated that the result here is "unwarranted taxation of capital gains as ordinary income." (R. 36.) As the Commissioner's brief comes to a close, all he can finally do is to fall back on the so-called "letter" of the statute. He "has no answer except to say that we are not free to depart from the literal meaning of the words, however transparent may be the resulting stultification of the scheme or plan as a whole." *Cabell v. Markham*, 148 F. 2d 737, 739 (2d Cir. 1945), *aff'd*, 326 U.S. 404 (1945). Here, of course, his so-called "literal" meaning is neither literal nor sensible. (Pet. 41-52.)<sup>37</sup> Even if the issue were more doubtful, the appropriate answer is the one that makes sense. So subsection (a) is construed, and so subsection (m) should be read. For they are interrelated parts of the same statutory scheme. (Pet. 51-52.) We submit that before a taxpayer is subjected to a heavy tax deficiency, the relevant statute should, at the very least, be construed in accordance with the purpose of Congress.

The nature of the Commissioner's construction is sufficiently shown by the distinction he would make between operating an enterprise as an individual and operating it through a corporation. In pursuit of its underlying purpose, section 117(m) seeks to equate the tax treatment of the two. It precludes a taxpayer from converting ordinary income into capital gain

<sup>37</sup> Cf. Hand, *The Spirit of Liberty* 156-157 (1952): "The duty of ascertaining its meaning is difficult enough at best, and one certain way of missing it is by reading it literally, for words are such temperamental beings that the surest way to lose their essence is to take them at their face. Courts must reconstruct the past solution imaginatively in its setting and project the purposes which inspired it upon the concrete occasions which arise for their decision."

through the process of incorporating the enterprise. However, the Commissioner's interpretation produces exactly the opposite result. If the petitioners had built and operated Oakland Gardens in their individual capacity, the profit realized on its sale would have been capital gain. According to the Commissioner, the same profit realized through a sale of stock is ordinary income. And this arbitrary incongruity, completely at odds with the aim of the statute, the Commissioner regards as a genuine "effort to produce a rational, sensible structure" in accordance with "the discovered purposes of Congress."

Only recently this Court disposed of a similar mode of construction in *United States v. Gilmore*, 372 U.S. 39 (1963). There, as here, an attempt was made to entangle the application of a tax statute in a distinction between an individual enterprise and a corporate enterprise. The Court refused to approve such "incongruities" of interpretation. As the Court stated, "It was manifestly Congress' purpose" in the area involved "to place all income-producing activities on an equal footing. And it would surely be a surprising result were it now to turn out that a change designed to achieve equality of treatment in fact had served only to reverse the inequality of treatment." *Id.* at 49. The Commissioner is trying to produce the same "surprising result" here, after deplored it in the *Gilmore* case. As he reads section 117(m), it is some special penalty imposed on those who do business through a corporation—even when they have to do business that way. See p. 49, *supra*. Compare, in regard to arbitrary incongruities, *Putnam v. Commissioner*, 352 U.S. 82, 92-93 (1956); *Colony, Inc. v. Commissioner*, 357 U.S. 28, 36-37 (1958).

One small matter remains. The Commissioner states that if our construction of the statute is correct, it is necessary to remand the case to the Tax Court. (Resp. 31; n. 28.) This suggestion, we gather, rests on the ground that the petitioners individually may have been in the business of constructing and holding apartment buildings primarily for sale to customers in the ordinary course of their business. However, there is no reason for any further proceedings here. The evidence and findings could not possibly permit any such conclusion in favor of the Commissioner. "To remand the cause for further findings would be futile." The Tax Court "could not properly find anything which would assist the Commissioner's cause." *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200, 207 (1935). Cf. *United States v. Wells*, *supra*, at 120-121; *O'Leary v. Brown-Pacific-Maxon*, 340 U.S. 504, 508 (1951); *Jacobson v. Commissioner*, 281 F. 2d 703, 706 (3d Cir. 1960).

As the findings and the uncontradicted evidence disclose, at no time throughout their careers in real estate did the petitioners hold, within section 117(a)(1)(A), apartment buildings or other rental properties primarily "for sale to customers" in "ordinary course." They were not dealers in such structures. (A. 99, 101, 106, 186, 250.) See also Pet. 3-4, 6.<sup>38</sup> Otherwise the opinion below was an academic exercise. Its entire discussion rests on the premise that if the petitioners had realized the same profit as direct owners of the property, it would have been capital gain. The very

<sup>38</sup> It was stipulated, as well as found, that the petitioners were not holding their stock in the corporations primarily for sale to customers in the ordinary course of business. (Pet. 39, n. 7.) And, needless to add, the Commissioner does not claim that the corporations were holding the development for any such purpose.

heading of the court's discussion states: "Section 117(m) applies even if sale of the corporate assets would have produced capital gain had no corporation existed." (R. 35.) Finally, the Commissioner himself agreed that the petitioners were not in the business of selling apartment buildings to customers in ordinary course, when he framed the question which is now before the Court. See p. 4, *supra*.

Respectfully submitted,

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## APPENDIX A

UNITED STATES TREASURY DEPARTMENT,  
INTERNAL REVENUE SERVICE,  
WASHINGTON, D. C., NOVEMBER 30, 1950.

Shirley-Duke Apartments, Section III, Inc.,  
Alexandria, Va.

(Attention Mr. Carl Budwesky, secretary.)

Gentlemen: Reference is made to your letter dated October 18, 1950, requesting a ruling as to the status, for Federal income tax purposes, of a proposed distribution to your stockholders.

It is stated that the corporation was organized under the laws of the State of Virginia for the construction and operation of an apartment development. It began construction in June 1949, which was financed by a mortgage loan of \$1,840,000. There are issued and outstanding 100 shares of first preferred stock of a par value of \$1 per share and 200 shares of common stock of no par value issued on a basis of \$5 per share.

The project was constructed by the corporation through its employees, who supervised the operations and let contracts for the various types of work to numerous contractors. Four of the stockholders were employed in this connection, and the compensation paid to them is set forth in your letter.

The construction has been completed, all costs have been paid, and there is remaining \$100,000 of the proceeds of the mortgage loan which the board of directors has transferred to capital account. It is proposed to distribute this sum to the shareholders in proportion to their holdings of stock. All such shareholders have held their respective shares for more than six months.

Based upon the representations in your letter it is held that upon distribution the amount distributed shall be

applied against and reduce the basis of the stock held by the receiving shareholder and shall be taxable to the recipient if, and to the extent that, the amount distributed exceeds such basis. The gain, if any, will constitute long-term capital gain in accordance with the provisions of section 117(b) of the Internal Revenue Code.

Very truly yours,

E. D. McLARNEY,  
*Deputy Commissioner*

**APPENDIX B****Administrative Rules for War Rental Housing Insurance Under  
Section 608, National Housing Act****(24 CFR, 1947 Supp., 580.1 to 580.41)**

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*§ 580.26 Requirements Regarding Form of Mortgagor.* In addition to meeting the requirements set forth in §§ 580.23 to 580.25, inclusive, the mortgagor must be:

(a) a corporation or trust formed or created, with the approval of the Commissioner, for the purpose of providing housing for rent or sale, and possessing powers necessary therefor and incidental thereto, which corporation, or trust, until the termination of all obligations of the Commissioner under such insurance, is regulated or restricted by the Commissioner as to rents or sales, charges, capital structures, and methods of operation to such an extent as may be deemed advisable by the Commissioner. Such regulation or restriction shall remain in effect until such time as the mortgage insurance contract terminates without obligation upon the Commissioner to issue debentures as a result of such termination. So long as such contract of insurance is in effect, the corporation or trust shall engage in no business other than the construction and operation of a Rental Housing project or projects . . . .

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(c) if the mortgage is not in excess of \$200,000, the mortgagor may be an individual.

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*§ 580.29 Regulation of Mortgagor by Commissioner in General.* A corporate mortgagor shall be regulated through the ownership by the Commissioner of certain shares of special stock (or other evidence of beneficial interest in the mortgagor) which stock or interest will acquire majority voting rights in the event of default under the mortgage or violation of pro-

visions of the charter of the mortgagor or the violation of any valid agreement entered into between the mortgagor, the mortgagee and/or the Commissioner, but only for a period coextensive with the duration of such default or violation. The shares of stock or beneficial interest issued to the Commissioner, his nominee or nominees and/or the Federal Housing Administration shall be in sufficient amount to constitute under the laws of the particular State a valid special class of stock or interest and shall be issued in consideration of the payment by the Commissioner of not exceeding in the aggregate \$100. Such stock shall be represented by certificates issued in the name of the Commissioner, and/or in the name of his nominee or nominees, and/or in the name of the Federal Housing Administration, as the Commissioner shall require. Upon the termination of all obligations of the Commissioner under his contract of mortgage insurance or any succeeding contract or agreement covering the mortgage obligation, including the obligation upon the Commissioner to issue debentures as a result of such termination, all regulation and restriction of the mortgagor shall cease. When the right of the Commissioner to regulate or restrict the mortgagor shall so terminate, the shares of special stock or other evidence of beneficial interest shall be surrendered by the Commissioner upon reimbursement of his payments therefor plus accrued dividends, if any, thereon. Such regulation and the additional regulation or restriction hereinafter provided in §§ 580.30 to 580.32, inclusive, shall be made effective by incorporation of appropriate provisions therefore in the charter or other instrument under which the mortgagor is created, or by agreement.

§ 580.41 *Effective Date.* This part is effective as to all mortgages on which a commitment to insure under section 608 is issued, on or after December 19, 1947, pursuant to an application for mortgage insurance filed on or after said date.